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THE MANAGEMENT OF THE SURPLUS RESERVE

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The surplus reserve of a corporation is the amount by which assets exceed liabilities. It consists of the accumulation of the amounts remaining out of income after fixed charges and dividends have been paid. The surplus is represented as a debit on the profit and loss account, and as a liability on the balance sheet. The purpose of its accumulation is either to guarantee the payment of interest and dividends, or because stockholders believe that the money which might otherwise be distributed among them will yield a larger return if left in the business of their company than in any other form of investment which is open to them. The profits of any business, unless it be the receipts of some public service corporations, are subject to wide fluctuations. The requirements for interest are constant, and the rate of dividend, if a corporation desires an investment position for its stocks, should never move except to increase. Out of this situation, arises the necessity of establishing the lowest point on the curve of profits as the maximum of distribution, and of employing the surplus over this amount, low in some years and high in others, in such a way as to add to the income.

The proportion of annual profits which should be reserved for the surplus by any given concern depends upon the regularity of the demand for the product. A railroad, for example, can pay out a higher percentage of the profits of prosperous years than can a steel manufacturing or a shipping concern. In other words, the liability item on the balance sheet of a steel manu-

facturing corporation which is called surplus, should bear a larger proportion to the sum of the liabilities than in the accounts of a railroad. It will finally be conceded that a company which is organized on a speculative basis and whose stock contains an excessive amount of water, should reserve a larger proportion of earnings than a company which is firmly established in the confidence of investors.

These principles of financial management are thoroughly understood and generally accepted by those who administer the finances of business concerns. Even when the necessity of making a market for speculative stocks compels the payment of the entire amount of profits to stockholders, the policy is sincerely regretted by those who adopt it and who usually sell their own holdings at an early date, thus manifesting, in a practical manner, their disapproval. There are, however, certain variations and applications of these principles which will repay investigation. We may consider the following problems which concern the management of the surplus reserve. First, the various forms in which the reserve may be invested; second, the apportionment of capital expenditures between earnings and the proceeds of capital sales; third, the relation of maintenance expenses to the surplus; and fourth, the methods by which the surplus is distributed to stockholders.

The ordinary form of the reserve is an investment in plant and equipment. It is rightly believed that money turned back into a going concern, especially when the demand for its products is increasing, will bring a larger return than when held in securities. It may be questioned, however, whether a portion of these reserves could not be invested to greater permanent advantage in securities which bear no reference to the business in

which the concern is engaged. In other words, may there not be an advantage to those enterprises whose earnings are most subject to fluctuations in building up out of earnings, reserves of good securities, from which they may draw at all times a steady income which no reverses of business can disturb, and which will enable their managers to operate at cost or below cost, if such a policy is necessary to maintain their market position and to keep their plants in operation? For many years the directors of the Pennsylvania Coal Company pursued this policy and placed all of their earnings above a moderate dividend in outside investments with the result that they were eventually able to pay their dividends without reference to their coal business. The great shipping companies of England and Germany follow a similar course, and place a large portion of their surplus earnings in outside securities. It is claimed that the Cunard Company, for example, might lose all its ships and still have 37 per cent of their book value remaining. A reserve of securities may also be drawn upon during a period of depression to maintain the dividend rate. This practice is general among shipping companies. If the surplus reserve is to be regarded as a fund laid aside for a rainy day, this practice may be approved. If, however, the surplus is looked upon as an integral part of the business equipment, and this seems to be a more accurate conception of its place in the corporate economy, than the payment of dividends out of surplus is to be condemned. The only surplus which is available for dividends is a surplus of earnings. In other words, a dividend should never be paid unless it has been earned in the year in which it is declared.

Aside from the stability which outside investment tends to introduce into the profits of a business, it is an

aid to credit. The time comes to every concern when the banks must be appealed to for funds, either to anticipate the sale of securities, or to advance the proceeds of bills receivable which a financial stringency has made it inadvisable to press for payment. This money can usually be borrowed on the credit of a going concern without special security. The obligation created is termed a floating or unsecured debt, as distinguished from a debt secured by lien on specific pieces of property. Other corporations, for example the Consolidated Lake Superior, in 1902, or the Philadelphia and Reading in 1892, unable to obtain money in return for their unsecured promises to pay, were forced to deposit a "sufficient" amount of collateral with the lender to secure the loan. The margin of security demanded is sometimes exorbitantly large. For example, the Philadelphia and Reading to secure a loan of $2,000,000 was forced to deposit $12,000,000 of collateral, most of which was worth its face value. The Consolidated Lake Superior Company more recently pledged all of its assets, representing the expenditure of approximately $28,000,000 to secure a loan of $5,050,000, and these were bought in by the lending syndicate for $4,500,000. In either case, whether collateral is deposited, or whether the credit of the corporation is utilized, the existence of an unfunded debt which will mature within a few months, is a menace to the solvency of the borrowing corporation. Under some conditions of the money market, as witness the bankruptcy of Reading, Erie, Atchison, and Norfolk and Western, it is impossible to secure an extension of these loans, and the corporation is forced into a receivership or is shorn of its assets by the sale of securities which represent them. The creation of floating debt, an almost universal feature of corporation finance, has

been frequently followed by these disastrous consequences.

If temporary loans could be made, on specific security, which did not represent assets indispensable to the borrower, a large use of credit would be much less dangerous than it is at present. In view of this fact would it not be wise for corporations to invest a portion of their annual profits in good securities? From these they might at all times derive at least four per cent and could also use them to raise money, when need arises, either by selling these holdings or by depositing them as collateral for loans. The collateral could be sold, if the borrowing corporation was unable to meet its obligations, without impairing the efficiency of the business. This plan has not yet in any large measure been adopted. It is true that American railway corporations are turning into finance companies. The Pennsylvania Railroad, for example, holds securities which stand on its balance sheet at a valuation of $225,000,000, and the New York Central and Union Pacific also own vast amounts of securities. None of these treasury assets, however, can safely be used as collateral for loans. They could not be sold without impairing the integrity of the system. They are not, in other words, "free assets." They were not purchased for investment but for influence and control.

This question of investing surplus in "free assets" is hardly as important for the railroads as for the industrials. Some of these companies have accumulated large floating debts without special security and which if not carefully managed may result in receiverships. Would it not be wise, therefore, to repeat, that companies the nature of whose business forces them to frequently apply to the banks, should accumulate a fund

of quick assets which may either render borrowing unnecessary, or if it is resorted to, may protect the borrowing corporation from serious embarrassment in case its loans are called at a time when funds are low.

The principles governing the amount of cash working capital which a concern should carry, and which is usually, after the initial subscription, provided out of earnings, are generally understood. The amount varies with the volume of the business, the conditions of raw material supply, the regularity of the demand for the product, and the customs which regulate payment. A railroad needs but a small working capital. A steel manufacturing corporation requires that a large amount of cash assets shall constantly be available.

We are particularly concerned in this discussion with the disposition of the cash balance. The cash capital of a large corporation is not at all times fully employed in the business. In order to make these cash balances productive, they are either invested in call loans or in bank deposits on which a small rate of interest is paid. In recent years a custom has grown up that bank officers should become directors in large corporations, with a view to mutual advantage. In return for preference loans when occasion requires, in anticipation of bond sales, for example, the corporation deposits its surplus cash in the banks with which it is thus informally connected, receiving a low rate of interest. There are a number of banks and trust companies in Philadelphia which are known as Pennsylvania Railroad institutions, since their officers are directors of that corporation. These arrangements are mutually profitable, and are increasingly common.

It may, however, be suggested that the arrangement would be more profitable to the corporation directors, if

they were stockholders in the banks which make such large profits by lending out their deposits. Certainly dividends of 10 to 30 per cent, which are often earned by the large institutions, would be an acceptable addition to the small interest which large corporations receive on their cash deposited. We may go even further. Since it is admitted that a corporation should carry on its balance sheet a considerable amount of "free" assets, the most profitable investment for these funds, profitable not merely from the direct return, in dividends, but from the more direct control over large cash resources which this ownership gives, would be large holdings of bank and trust company stock.

It may be objected that the deposits of the community should not be jeopardized by such intimate connection with the interests of large corporations, but to this the answer is that the connection now exists, that the depositor has not frequently suffered, and that if corporations were recognized as the principal owners of banks, not merely would the force of public opinion be brought more directly to bear in forcing them to exercise due caution in their management, but the depositors would be fully informed as to the control of their deposits.

We have in the second place to consider the division of betterment expenses between profits and the proceeds of capital sales. Mr. Stephen Little, to the value of whose labors in creating a body of scientific knowledge in the field of accountancy no tribute can be too high, is to be credited with the first authoritative statement of the principle which applies in such cases, although the practice of many corporations had been conformed to the rule of policy which he laid down. In 1896, in a report of the financial condition of the Baltimore and Ohio Railroad Company, Mr. Little claims that no ex-

penditures should be charged to capital account, which did not result in an immediate or, at any rate, an early increase of income. By this he did not, of course, mean that railway earnings, no matter how prudent the policy of management, would not suffer periodical declines, but that in each particular case where money was to be spent for improvement, the character of the improvement should determine the source from which the funds should be provided. This portion of Mr. Little's report was not well received. The policy which he advocated was held to be impracticable and even absurd. A leading financial journal went so far as to say that an attempt to put this policy into operation would compel all improvements to be made out of earnings, since the profitableness of no expenditure could be assured in advance. Mr. Little lived long enough, however, to see his principle accepted as the settled practice, if not the avowed policy of American railroads.

Poor's Manual supplies us with a striking illustration of the method of its application: From 1898 to 1902, railway mileage in the United States, including second track in the estimate increased 29,000 miles, equipment increased 4880 locomotives and 219,142 cars, and terminals, yards and the other portions of the railway plant increased in proportion. The cost of road and equipment representing approximately the improvement charges to capital account, increased $609,407,791, and the total surplus during these five years was $375,-678,615. If the amounts reserved out of earnings for so-called extraordinary expenditures be added to this accumulated surplus, for this purpose since 1898, the total amount expended on the railway plant out of railway earnings, we are safe in saying, largely exceeds the amount raised for this purpose by the sale of stock and

bonds. The cost of that portion of the increase of railway assets whose return may be considered in a sense problematical and uncertain, was equally divided between earnings and the proceeds from the sale of new capital.

In apportioning these expenditures, there has been a rough approximation to the principle laid down by Mr. Little. The proceeds of stock and bond sales have been generally invested in equipment, second track, extensions or enlargement of terminals, forms of investment, in other words, which are likely to be immediately profitable, and on the other hand, the reservations from income have been put into forms in many cases indirectly and remotely productive.

A good illustration of this classification of expenditure is furnished by the extraordinary expenditures of the Pennsylvania for 1902. These included, among other items, the elevation of the tracks through Newark and New Brunswick and the revision of the line through Trenton to eliminate the grade crossings in these cities. The change of line at Trenton involved the construction of a stone bridge over the Delaware, and a change of tracks on the opposite of the river to correspond. We find also among these extraordinary expenditures such items as the substitution of stone for iron bridges, and the improvement of passenger stations. The return on these investments, as above remarked, is not immediate. Some years may elapse before a profit is earned. It is proper, therefore, that the earnings of the road should provide the money. On the other hand, the building of the new freight line around Pittsburg, the four tracking of portions of the line, the construction of classification yards and the reduction of grades and curves will immediately increase the earnings of the Pennsylvania, and are, therefore, proper objects for the increase of

capital. These so-called extraordinary expenditures do not, as a rule, figure in the balance sheet. The value of the assets which they represent is yet uncertain, and conservative management will not add the amount of these expenditures to the surplus, although if they justify themselves, the stockholders will eventually reap the benefit, either in an increase of dividend rate or in distribution of assets.

I am aware that this dividing line between the investment of earnings and the investment of the proceeds of bond sales is not rigidly adhered to, nor would I deny that earnings may not, on occasions, be invested in forms which will yield a large return, or that all investments of earnings, if wisely made, will not be ultimately profitable. Generally speaking, however, in spite of the conspicuous instances to the contrary which are furnished by the betterment policy of the Lehigh Valley and the Southern Pacific, Mr. Little's principle has been accepted and systematically applied by American railroads in the management of their capital account. Stockholders of prosperous and established companies have a right to demand that when a large margin over fixed charges or dividends is immediately assured on the investment of capital, the amount necessary should be raised by the sale of securities, and not taken out of earnings. They are equally concerned to protest against a policy which goes to an extreme in this direction, and distributes nearly all the earnings, while raising money by the sale of bonds for constructiou whose profitableness, while assured, is not likely to be immediately conspicuous.

The betterment policy of the Lehigh Valley is a forcible illustration of the injustice which may be done to stockholders by abnormal reservations from earnings.

This company, since 1899, has earned enough to pay a 4 per cent dividend and to be able to borrow at low rates of interest. Instead of paying a dividend, however, from 1898 to 1902, the directors spent $12,800,000 upon the property out of the net earnings of the company—$2,500,000 per year. If one-fifth of this amount had been devoted to interest payment, the amount required for the reconstruction of the property could have been borrowed, and over $5,000,000 could have been safely paid in dividends. The policy of the Canadian Pacific and of English companies, on the other hand, illustrates the risk of paying for betterments of doubtful profit out of the proceeds of capital sales.

Passing to the third division of the subject, we may raise the question whether abnornal operating expenses should properly be added to the surplus. The majority of railway companies increase their maintenance charges during periods when profits are large to an extraordinary degree. It has been argued, notably by the Interstate Commerce Commission, in a notable opinion on the advance of grain rates to the Atlantic seaboard, that large operating expenses were used to conceal profits, and that in addition to large dividends, certain companies were accumulating a large surplus none the less valuable because its annual increments are apparently swallowed up in the cost of operation.

This opinion, which is widely held, will not stand the test of critical examination. The large maintenance expenditures of the railroads during periods of prosperity are not properly to be included in a discussion of the surplus reserve. It is true that the unequal distribution of maintenance expenses, which rise and fall with railroad earnings, may be considered as a resource upon which, in lean years, the companies may

draw, and thus maintain the dividends. For example, take the item of rails. A steel rail may be expected to give service between fifteen and twenty years before it is finally scrapped. The strict requirement for maintaining the rails is, therefore, that at least one-fifteenth of the track should be relaid each year. If, however, in a year of large earnings one-tenth of the mileage is relaid, less than one-fifteenth can be relaid during the next year without allowing the condition of the property to deteriorate. This rule also applies to the maintenance of equipment and structures. Over a period of years a certain amount must be spent in repairs. These expenses, however, may be concentrated into a portion of the period, and by reducing maintenance charges during lean years an extreme reduction of net earnings may be prevented.

An illustration of the advantages of this method of concentrating operating expenses into the years of large earning for the benefit of dividends during periods of depression is furnished by the experience of the Burlington from 1887 to 1891. Owing to a large construction of new mileage and to a combination of unfavorable circumstances the surplus over fixed charges decreased from $2,596 per mile in 1883 to $484 in 1891. As a result the dividend was reduced from 8 to 5 per cent. The dividend, however, must have been entirely suspended had not the company been able to make large reductions in its maintenance charges. The heavy maintenance expenses of the Burlington during the years of large earnings could not properly be considered as additions to the value of the property, because they did no more than enable the company to maintain a moderate dividend during a period of depression. Furthermore, in view of the fact that railway compa-

nies, as a rule, do not maintain depreciation accounts, in spite of the fact that their plant is liable to the same process of decay as the equipment of mining or manufacturing companies, and that their equipment is constantly being thrown out of use by the introduction of improved appliances, it is safe to say that even if these charges to maintenance expense on their face appear to be most excessive, and even if this excess is maintained during periods of depression, it is no more than a fair equivalent for the depreciation charge which should appear on their profit and loss accounts.

We turn, in conclusion, to consider the methods by which the surplus may be distributed to stockholders. There is no intention that the benefit of these reservations from profits for productive expenditure should be permanently withheld from the owners of the corporation. At irregular intervals, when the margin of safety for the dividend requirements is sufficiently great, the surplus is distributed to stockholders. Various methods may be employed to accomplish this result. The rate of dividend may be increased, or the assets of the company may be directly distributed to stockholders, either by means of a stock dividend, or what is known as a privileged subscription. The first method is less employed than the second. It is considered undesirable that the dividends of the corporation should exceed a moderate rate, say 5 or 6 per cent, not only because public hostility is aroused by the appearance of excessive profits, but because the market value of the stock, after a moderate rate of dividend has been reached does not advance proportionately with the increase in the rate of distribution. In other words, one share of stock which pays 12 per cent in dividends will under ordinary conditions sell for a much smaller amount of money than two shares of equal par value on which a 6 per cent dividend is paid.

The method of privileged subscription is therefore the one which is usually adopted. This method is familiar, and consists in offering new issues of stock to holders of record at a price below that which prevails in the market. A stock which may be selling at 150 in the open market may thus be offered to stockholders at 110. The stockholders may profit from this privileged allotment in two ways: either by holding the new shares and receiving the large return on the purchase price which the regular rate of dividend represents, or by selling his allotment in the market. This second transaction can be easily financed. The stockholder may sell short the number of shares which he is to receive and make his final delivery when the stock is issued, or, and this is the method commonly employed, he may sell his right to subscribe to the new stock, which is usually quoted on the exchanges. One advantage of this method is that apparently no distribution has been made. The liabilities of the corporation stand on its books at par, and there is no necessity of entering the result of a privileged subscription on the profit and loss account as discount on securities sold. In fact, the results of the transaction do not appear on the books of the company. The operation, nevertheless, results in a loss to the corporation. This may be understood if we conceive that the new stock which is to be issued is placed in the treasury of the company at a valuation which corresponds to the price which will be paid for it in the open market. If, now, this stock which is worth to the company 140 or 150 is sold to the stockholders at 110, the company has sustained a lost represented by the difference. The privileged subscription is, in fact, a distribution of the undivided equity in the company to its stockholders. This method is probably selected, as above remarked, be-

cause it is the method least understood by the public, and because, on that account it, seldom arouses comment, much less the opposition with which the declaration of a stock dividend would probably be saluted.

In conclusion, it may be of interest to observe that the general practice of offering securities on privileged terms to stockholders makes the return on many high grade stocks over a term of years considerably larger than the product of dividing the rate of dividend by the market price at any given time. These occasional profits, while reasonably assured, are too irregular and fortuitous to have more than a speculative influence upon the price of shares which are thus benefited. They do not, therefore, except for the period immediately preceding the distribution, figure in the investment judgment of the value of the stock. In other words, the investor who buys a 5 per cent stock at 120 has apparently invested his money at a rate of 4.2 per cent. If he holds his stock for ten years, however, it is altogether probable that, as a result of various privileged allotments and subscriptions, his return will be much larger.

For example, take the return on Illinois Central stock from November 1895 to August 1902. During this period the company paid a dividend of 5 per cent up to 1900 and 6 per cent thereafter and the price rose from 95 to 148.75, representing at the first date a return of 5.2 per cent, and in August, 1902, a return of only 4.1 per cent. On an average of the entire period, the yield on Illinois Central stock was not far from 4.1 per cent, a low rate of return. During these five years, however, the owners of Illinois Central participated in five privileged subscriptions, amounting in all to 70 per cent of the recorded holdings. An owner of 100 shares

who participated in the allotment, and who sold his stock immediately on delivery at the ruling market price, made a total profit of $2509.60, or 25.74 per cent on the market value of 100 shares at the date of the first allotment. Considering all losses and gains from the sale of the privileges, as distributed equally to December of the years 1896 to 1903 inclusive, the annual gain to the holder of 100 shares on the basis of the market price of November, 1895, was 2.69 per cent, making the annual return on the stock if purchased at that date 7.89 per cent. Of course, if the stock had been purchased at the higher prices, the gain would have been less, although still above the rate of dividend on the stock. If the stockholder prefers to hold his stock allotment, he can gradually raise the rate of return on his holdings to the dividend paid on the stock.

It is true that the stockholders of every corporation cannot look for as favorable terms as those granted by the Illinois Central, and in some cases, such for example, as the last issue of Pennsylvania stock, which was offered to shareholders at 120, the stock could have been afterward purchased below the subscription price. Generally speaking, however, stockholders of corporations whose dividends are reasonably well assured, and which sell at high prices in consequence, can materially increase their income by selling their stock allotments.

May we not hope that, when the public learn that the standard railway stocks offer the investor, along with the certainty of a moderate return, a strong probability of extra profits on privileged subscriptions, the demand for speculative stocks sold on representations of abnormal dividends may be greatly weakened, even if it can never be entirely destroyed?